

Private Company Financial Reporting Committee

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JUDITH H. O'DELL
Chair

May 23, 2008

Mr. Robert Herz
Chairman
Financial Accounting Standards Board
401 Merritt 7
Norwalk, CT 06856

Re: FASB Preliminary Views, *Financial Instruments with Characteristics of Equity*

Dear Mr. Herz:

The Private Company Financial Reporting Committee (“PCFRC”) offers the following recommendations and observations on the FASB Preliminary Views, *Financial Instruments with Characteristics of Equity* (“PV”). The recommendations and observations represent the unanimous views of the PCFRC members.

We understand that the FASB and IASB are working on this project jointly and have a common goal of reducing complexity. While the PCFRC believes the PV will more significantly affect uniquely structured private companies and those that compete for capital, we also believe the PV will affect a broader group of private company constituents and could unfortunately serve to increase complexity and decrease comparability. Therefore, we provide some recommendations and observations that are applicable to private companies, in order for them to be considered as the project progresses.

In the PV’s Summary of Issues, the FASB solicits comment on specific issues. We have included responses to certain of those issues within our recommendations and observations below, but also provide the overall private company constituent perspective.

Observations – Basic Ownership Approach - The PCFRC observes that under the Basic Ownership approach there could be unintended effects on private companies as a result of the classification of financial instruments as liabilities, the complexity infused into the model due to the measurement requirements, and the introduction of charges to the income statement related to ownership.

Classification of instruments as liabilities

As noted in paragraphs D1 through D7 and D22 of the PV, the classification as liabilities of instruments other than very basic equity instruments, appears inconsistent with the current definition of a liability. Further, we believe equity classification should be from the issuing entity's perspective, not from the investor's perspective of perceived return characteristics.

Private equity investors, such as venture capital and buyout investors, make equity investments in companies because they expect equity returns. Venture investors generally have the only significant equity in the form of cash contributed in their portfolio companies. The common stock is generally held by founders and employees who have relatively little cash invested in the business. The venture capital firm protects its cash capital invested in the business by getting a priority return over the common stockholders while still giving the common stockholders an interest in the value of the business.

Lenders will provide financing to venture-backed companies based on the equity invested by the venture investors. Lenders consider the disclosure of the terms of the instruments in their lending decisions. Classifying the venture investment as a liability will not result in meaningful financial statements to users of private company financial statements. The PCFRC understands that financial statement users vary in sophistication, and so an emphasis on disclosure requirements is important to ensure suppliers, customers, and lenders are receiving sufficient information about the instruments. However, we believe that even with sufficient information, the classification of the instruments as liabilities could cause confusion among less sophisticated users that use financial statements to make credit decisions. These financial statement users may be unsure that the company being reviewed has sufficient capital to stay in business over some intermediate term. We acknowledge that this can be addressed through training and/or changes to the financial statement users' business model, but the costs of that could be significant to both the preparer and user.

Measurement complexities and income statement impact

The preference to use the Basic Ownership approach in the PV may be relevant from the perspective of existing common stockholders of public companies, where “stock issuance is often a readily accepted substitute for cash payment because if the markets are deep and liquid the two are interchangeable for many entities.” This is not the case for private companies, where equity issuances generally are not substitutes for cash payments. Owning a security with a current cash redemption right is much different from owning a security that is redeemable for shares. Thus a key premise of the Basic Ownership approach would not apply to private companies. Yet, the Basic Ownership approach in the PV would add costly complexities to private company financial statements by requiring regular fair value measurements of instruments and components classified as liabilities.

Furthermore, under the Basic Ownership approach, including in the income statement the changes in the fair value of an instrument which is convertible into common stock would cause the income statement to be less useful for users of private company financial statements. An entity that has no current requirement to redeem a security for cash, should not have to record changes in the value of that security on its income statement, especially when the changes are solely attributable to the ability to convert the security to common stock.

Recommendations/Observations - Impact on uniquely structured private companies

Employee Stock Ownership Plan (“ESOP”)-owned private companies

The PV does not appear to address common stock owned by ESOP-owned private companies. We ask for clarification on the FASB’s view on the impact of the Basic Ownership approach on these kinds of uniquely structured private companies. How would the PV work in conjunction with SOP 93-6, *Employers’ Accounting for Employee Stock Ownership Plans*, (“SOP 93-6”)? The Basic Ownership approach potentially would result in 100% ESOP-owned private companies never having equity on their balance sheets. Most ESOP-owned private companies have provisions in their corporate bylaws and/or ESOP documents that prohibit participants from taking company stock with them when they exit the plan. Instead, such participants are required to redeem their allocated shares to the sponsoring company or the ESOP at the shares’ current fair value. According to the PV, this mandatory redemption feature dictates that the subject shares qualify as basic ownership instruments only if they possess both of the two characteristics described in paragraph 20 of the PV.

Clarification of the meaning of paragraph 20a as it relates to these kinds of features would be helpful. Generally, as mentioned above, shares in an ESOP setting are redeemed at their estimated fair value, not their liquidation value. In a normal liquidation, as we understand paragraph 20a, a company's creditors would have a priority claim to its net assets before common shareholders would receive anything. We are unclear about both the intent and the implementation of this criterion, even after reading paragraph 57. Also, most ESOP-owned private companies would not meet the criterion described in paragraph 20b of the PV.

If the FASB continues with the Basic Ownership approach, the PCFRC recommends that the common stock owned by ESOPs be automatically deemed to meet the definition of a basic ownership instrument in paragraph 18 of the PV. We believe this would result in the classification outcome depicted by the example at the end of paragraph 33 of the PV. Alternatively, we recommend the FASB consider an exemption from the final standard for ESOP-owned stock of entities that fall within the scope of SOP 93-6, which has provided consistent, high quality measurement, classification, and disclosure requirements for ESOP-owned private companies.

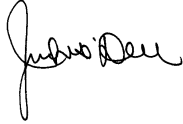
Recommendation – Ownership Settlement - the Ownership-Settlement approach appears to be a foundation of principles that can be built upon to improve financial reporting without adding complexity.

The PCFRC believes that the Ownership Settlement approach is a preferable approach, which includes enhancements to current GAAP. In some cases, this approach will bifurcate the more complex instruments, giving users a clearer picture. Although challenges exist with the Ownership Settlement approach that need to be addressed, it presents a better alternative than the Basic Ownership approach. Instruments whose value fluctuates primarily with (and in the same direction as) the value of the issuing enterprise as a whole, as opposed to the ability of the enterprise to repay the holder a stated amount, are distinguishable as equity instruments.

As the project progresses, the PCFRC will continue its work on this topic and continue to evaluate its effect on private companies. The PCFRC may issue further recommendations and observations to the FASB on this project. The PCFRC appreciates the FASB's consideration of our recommendations and

observations. Please feel free to contact me if you have any questions or comments.

Sincerely,

A handwritten signature in black ink, appearing to read "Judith H. O'Dell". The signature is fluid and cursive, with a prominent initial "J" and a long, sweeping tail.

Judith H. O'Dell
Chair
Private Company Financial Reporting Committee